RESTRICTIVE TRADE PRACTICES COMMISSION

Telecommunications in Canada

Part II
The Proposed Reorganization of Bell Canada

RESTRICTIVE TRADE PRACTICES COMMISSION

TELECOMMUNICATIONS IN CANADA

PART II

THE PROPOSED REORGANIZATION OF BELL CANADA

Report in the Matter of an Inquiry under section 47 of the Combines Investigation Act relating to the Manufacture, Production, Distribution, Purchase, Supply and Sale of Communication Systems, Communication Equipment and Related Products

Ottawa

1982

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RESTRICTIVE TRADE PRACTICES COMMISSION

TELECOMMUNICATIONS INQUIRY

Member R.S. MacLellan, Q.C.

Member F. Roseman

Restrictive Trade
Practices Commission

Commission sur les pratiques
restrictives du commerce

July 26, 1982

The Honourable André Ouellet, P.C., M.P.
Minister of Consumer and Corporate Affairs
House of Commons
Ottawa, Ontario
K1A 0A6

Dear Sir:

I have the honour to transmit to you, on behalf of Mr. MacLellan and myself, the French and English texts of Part II of a report entitled "Telecommunications in Canada - Part II - The Proposed Reorganization of Bell Canada". Mr. Couture, who served as Chairman of this inquiry until his retirement, has been given the opportunity to read this report, and he is in full agreement with it.

The remaining questions pertaining to this inquiry will be covered in a forthcoming report.

The present report follows from an inquiry carried out under section 47 of the Combines Investigation Act relating to the manufacture, production, distribution, purchase, supply and sale of communication systems, communication equipment and related products.

Yours very truly,

F. Roseman

Frank Roseman
Member

CHAPTER I

INTRODUCTION

This is Part II of the Commission's report on its inquiry into the Telecommunication Equipment Industry. It is the first time that an inquiry by the Commission has resulted in a report in several parts. Rapidly moving events relating to this inquiry, which has been long and has dealt with complex matters, made it necessary that the Commission depart from past practice. Part I, which dealt with the attachment of terminal equipment to the public switched networks, was issued separately in order that the Commission's views and the material received by it could be presented in time for them to be of use during the formulation of policy on this important matter.

As in the case of Part I, this part of the report is issued in response to recent events which made the planned date of the final report, this winter, too late to provide an input in an important area of the inquiry which is being affected by these events. The matter in question is the proposal by Bell Canada for its reorganization. This Commission learned of the proposal through newspaper reports of June 24, 1982, and subsequently took steps to inform itself as to whether the proposed reorganization was within the terms of reference of the inquiry. A letter (Appendix I) was sent to Bell Canada, through its counsel in the inquiry, on July 8, 1982. The Commission was advised that the information required by it is contained in

Bell's Information Circular to its shareholders, dated June 25, 1982. A letter dated July 21, 1982 from Bell Canada's solicitors in answer to questions of the Commission is attached as Appendix II.

This circular appears to answer the Commission's questions, either directly or by implication. A critical question is whether the proposed reorganization lies solely within the authority of Bell Canada and its shareholders and the Superior Court of Quebec, which is being approached on what, on the face of it, is a very narrow question concerned solely with the interests of shareholders.

Given that the reorganization could have far-reaching effects, the Commission wished to ascertain whether Bell needed the approval of Parliament for the change and whether the Canadian Radio-television and Telecommunications Commission (CRTC) had to be consulted. In the event that approval from either or both bodies was required, the Commission would have had time to issue a second and final report which would have contained its views on the proposed reorganization in the context of an overall discussion of the telecommunication equipment industry. However, it is Bell's belief, as stated in the Information Circular, that "The proposed Reorganization is not subject to CRTC approval." Bell's view that the proposed reorganization is not prevented by its *Special Act* is stated in the following:

> "The Reorganization will not be consummated unless the following conditions have been met:
>
> ...

> "Bell Canada shall have received a legal opinion from counsel (who may be internal counsel to Bell Canada) satisfactory to the Board of Directors of Bell Canada relating to the Reorganization, including an opinion to the effect that Bell Canada is not a party to, bound by or subject to any law, regulation, judgment, indenture, agreement, charter or by-law provision which would be violated, contravened or breached by, or under which default would occur as a result of, the consummation of the Reorganization, where such violation, contravention, breach or default would materially and adversely affect Bell Canada or BCE;*..."

Another matter about which the Commission sought information was with regard to possible changes in the relationships between Bell Canada, Bell-Northern Research Ltd., and Northern Telecom Limited. According to Bell's reply letter, the process and funding of product development will not be affected by the proposed reorganization, nor are changes planned with respect to Bell's supply agreement with Northern.

Although there are a number of positive aspects to the proposed reorganization that deserve consideration, in the Commission's view the proposed reorganization has serious implications for the distribution of benefits that Northern derives from its vertical relationship with Bell. As will be discussed subsequently, the implementation of Bell's proposal would result in a serious inequity in favour of Bell's shareholders at the expense

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* Bell Canada Enterprises, Inc.

of its subscribers. There are two considerations which have guided the Commission in deciding that the distribution of benefits falls within its terms of reference. Firstly, the benefits in question result from the structure of telecommunication equipment markets associated with the vertical integration of Bell and Northern. Secondly, the Commission is bound under its governing statute in a section 47 inquiry to make recommendations with respect to the public interest. It would require a very narrow view of the public interest to conclude that dealing with the inequity *per se* will not change the monopolistic situation and that therefore the inequity is not within the Commission's terms of reference. It is relevant to note that the distribution of these benefits is a matter on which the Commission sought information during the inquiry from expert witnesses from the firm of Price Waterhouse & Co. In taking a reasonably broad view of the public interest, the Commission also recognizes that it is often in a unique position to obtain a broad overview of an industry during the course of a general inquiry under section 47.

Although the question of fairness emerges most prominently from the proposed reorganization, there is another implication that relates to equipment purchasing by Bell.

Bell's proposal and the steps which have been undertaken by Bell to implement it are treated in Chapter II. Chapter III deals with the implications of the proposal for Bell's vertical relationship with Northern Telecom and for Bell's subscribers. The final chapter contains the Commission's recommendation.

CHAPTER II

THE PROPOSED REORGANIZATION

Under the proposed reorganization, Bell Canada's common and preferred shareholders would become the common and preferred shareholders in Bell Canada Enterprises Inc., and Bell Canada would become a wholly-owned subsidiary of BCE. This company, which has been incorporated under the *Canada Business Corporations Act*, is, under its charter:

> "... empowered to make any investment without being subject to restrictions or prohibitions and, as a result, its investment powers are broader than those that may be considered to be vested in Bell Canada."*

BCE would raise equity capital for Bell's needs and those of its other wholly-owned subsidiaries. Bell and these companies would raise their own debt capital.

Bell's transfer of ownership in a number of subsidiary companies would be accomplished by means of the creation of two series of Second Preferred Shares.

> "The redemption price of the Second Preferred Shares, Series One, will equal the historical cost to Bell Canada of the transferred investments. The redemption price of the Second Preferred Shares, Series Two, will equal the excess of the net realizable value of the investments

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* This quotation and all subsequent ones are from the Information Circular.

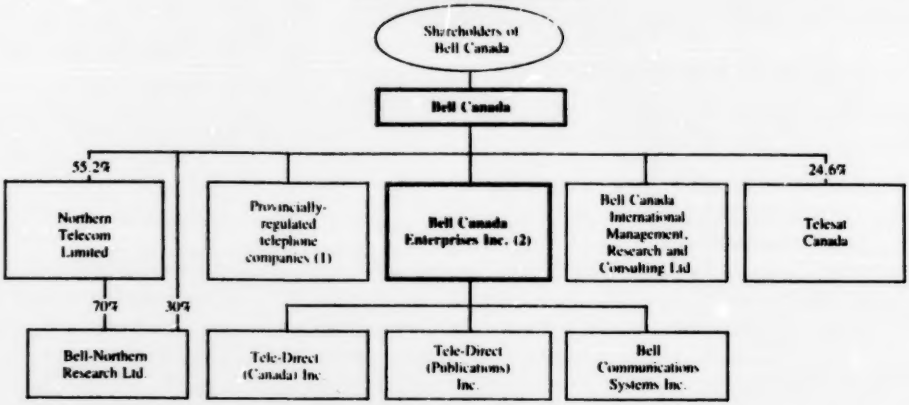
> over their historical cost. ... In the Post-Arrangement Transactions, BCE will redeem the Second Preferred Shares, Series Two, simultaneously receiving a dividend from Bell Canada in the same amount."

Thus, following the arrangement, the paper transaction described in the last sentence of the quotation would result in the capital gain on the shares of Bell's subsidiary companies accruing to BCE; i.e., Bell Canada's shareholders. According to the information circular, the amount of this gain would be approximately $560,000,000, based on the share prices as at June 15, 1982. The capital gain over book value in Northern's shares alone is discussed in Chapter III. The Second Preferred Shares, Series One would replace the book value of the shares on Bell Canada's balance sheet. They would be redeemed within five years.

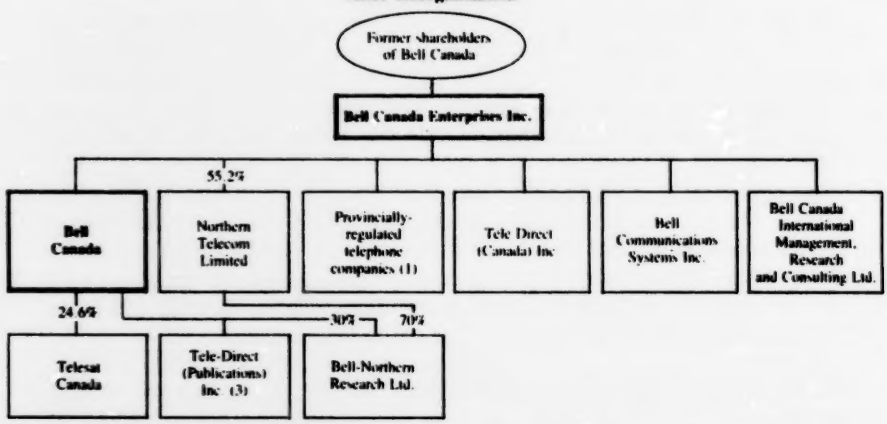
> "The Investments consist principally of Bell Canada's 55.2% ownership of Northern Telecom Limited and of Bell Canada's investments in the following companies: Maritime Telegraph and Telephone Company, Limited; Télébec Ltée; The New Brunswick Telephone Company, Limited; Newfoundland Telephone Company Limited; Northern Telephone Limited; Bell Canada - International Management, Research and Consulting Ltd.; The Capital Telephone Company Limited and The North American Telegraph Company."

The current corporate structure and the structure after reorganization are set out as follows in the information circular. "All companies are 100% owned unless otherwise indicated."

Current Corporate Structure



After Reorganization



(1) Newfoundland Telephone Company Limited, 63.5% owned; Northern Telephone Limited, 99.8% owned; The Capital Telephone Company Limited, 100% owned; Télébec Ltée, 100% owned; Maritime Telegraph and Telephone Company, Limited, 35.4% owned; The New Brunswick Telephone Company, Limited, 35.8% owned.

(2) Formerly named Tele-Direct Ltd. Tele-Direct Ltd., formerly a wholly-owned subsidiary of The Capital Telephone Company Limited, became a direct, wholly-owned subsidiary of Bell Canada on June 11, 1982. Tele-Direct Ltd was renamed Bell Canada Enterprises Inc. on June 22, 1982 and a new company was created named Tele-Direct (Canada) Inc. to carry on printing, publishing and related businesses.

(3) It is intended that as soon as practicable after the Reorganization this corporation will be transferred by BCE to Bell Canada. The description reflects this eventual transfer.

The proposed reorganization, in the opinion of Bell's Board of Directors, "should permit the Bell Group to respond more effectively to challenges presented by certain recent developments." It is noted that, firstly, the Bell Group is engaged in a number of diverse activities. Secondly, under the present structure income from both regulated and non-regulated activities must pass through Bell and is therefore subject to regulation by CRTC.

> "With the non-regulated income commingled with the regulated income in this fashion, the proper sharing between subscribers and shareholders of the risks and rewards associated with these investments has become a major regulatory issue."

Elsewhere in the Information Circular it is pointed out that the CRTC had ruled, in its Decision 81-15,

> "... that the required return on Bell Canada's average total investment in all other subsidiary and associated companies will be deemed to be 15.5 per cent on an after-tax basis."

Finally, the competition resulting from the CRTC's interim decision on customer-provided equipment is seen as likely to persist following the CRTC's final decision.

CHAPTER III

SOME IMPLICATIONS OF THE PROPOSED REORGANIZATION

The concern of the Commission regarding the proposed reorganization arises because the positions of shareholders and subscribers in a regulated industry are not those normally associated with corporate owners and customers. In an ideal regulatory environment, shareholders are allowed the same rate of return that they would earn if the corporation were operating under competitive rather than monopolistic conditions. This means that the returns allowed them should reflect the cost of money as well as any market risks associated with the supply of services by the regulated firms, such as those due to seasonal or cyclical variations in demand. The shareholders should earn no more or less than the return required to elicit equity capital. Given that the flow of information to the regulator is (almost necessarily) incomplete and that there are lags in regulatory responses to changed circumstances, the actual return at any time may be above or below the target rate of return. However, for purposes of the present discussion, the goal of regulation is more important than the extent to which it is attained. The effect of the above is that the shareholders in a regulated company tend to assume the characteristics of bondholders. They are concerned primarily with a regular flow of dividends rather than with the capital gains associated with equity investment in a risky competitive industry. A

Price Waterhouse review of investment-dealer reports on Bell Canada concludes that these suggest that stock purchase recommendations have been based on rising earnings sufficient to permit regular increases in the common dividend. One institutional investor characterized Bell's common shares as an indexed debt instrument.

Nonetheless, it is the shareholders who will receive the capital gain that results from the proposed reorganization. This was also the case with the sale of shares in 1974, 1975 and subsequently as the result of the exercise of warrants which resulted in a very large capital gain. Evidence submitted by witnesses from Price Waterhouse & Co. shows that the amount of the gain from the sales referred to was $126.5 million. To the knowledge of the Commission all of this gain was permitted by Bell's regulators, without comment, to be taken by Bell's shareholders.

Based on the December, 1980 book value of Northern's shares to Bell and the current market value of those shares, by far the greatest part of the $560,000,000, and perhaps more than this amount, would be derived from Northern's shares.* A strong case can be made that most of the increase in the value of Northern's shares held by Bell should accrue to the subscribers who, in a rate-of-return regulatory environment, were the real, if

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* The excess of market value (July 16, 1982) over book at December 31, 1980 is $659.3 million. This figure indicates the magnitude involved, but is not precise since there have been additional transactions since that date.

unknowing, risk takers in Bell's reliance on Northern as its principal supplier. Bell Canada purchases the major portion of its telecommunications equipment from Northern pursuant to their supply agreement, under which Northern agrees, to the extent reasonably required for Bell Canada's business, to manufacture and sell materials to Bell, to prepare equipment specifications for Bell, and to perform installations, repairs and other services as specified. Northern's prices to Bell are to be at least as low as those offered to other customers under comparable conditions. In 1969, Bell purchased almost 90 per cent of its telecommunication equipment from Northern. This percentage declined somewhat over the decade. However, payment data covering the period 1975-78 show that over these years approximately 83 per cent of Bell Canada's payments for telecommunication equipment were made to Northern.

At the same time, Bell has been Northern's most important customer. While its importance has been declining as Northern achieves sales outside Canada and enlarges the scope of its operations, Northern's manufacturing sales to Bell in 1979 and 1980 nonetheless equalled almost one third of its total manufacturing sales. Manufacturing sales to Bell are virtually all sales of telecommunication products, and the Bell market accounted for 36 per cent of such sales in 1980 and over 40 per cent in 1979. Bell was, of course, even more important to Northern in earlier years. Bell also serves as a "showcase" for Northern products, which helps Northern in other markets. Additionally, information on Northern products is made available to some other telephone companies through Bell's service agreements with them.

Bell and Northern, in conjunction with BNR, have jointly developed many of Northern's successful products. Testimony during the inquiry highlighted the importance of this joint development to Northern, as witnesses traced Northern's ability to enter the market early with leading-edge products to the company's vertical relationship with Bell. Northern receives timely and complete (including proprietary) information from Bell in an ongoing fashion. Bell, through costs borne by subscribers, was an important supporter of research carried on by Bell-Northern in the early years after its formation. When BNR was originally formed, Northern was relieved of the burden of some of its R&D expenditures. These expenditures had increased from $13 million in 1964 to $31 million in 1970. In 1971, the year in which BNR started to operate, Northern's R&D expenditures dropped to $29.7 million, and were $28 million in 1972. It was 1973 before they surpassed the 1970 level. Bell and Northern now own 30 per cent and 70 per cent, respectively, of BNR, corresponding to their funding of that company. When first established Bell's share was 50 per cent, reflecting a greater reliance in the past on Bell as a source of operating revenues for the research subsidiary. Its share of these revenues was approximately 42 per cent for 1971-73.

The proposed restructuring also has implications with regard to the future purchasing practices of Bell from Northern. A necessary ongoing concern when preferred status is conferred on a supplier of a regulated company is whether the regulated company

is purchasing the best equipment for its needs, and at the lowest possible prices. The concern exists because firms subject to price regulation through the establishment of rate-of-return standards are more or less in a cost-plus situation. Unnecessary costs get built into the rates paid by the subscribers without any impact on shareholders in the long run. Under the existing ownership relationship between Bell and Northern, subscribers benefit from Northern's success because dividends from Northern flow directly to Bell and help to reduce the amount of rate increases. Under the proposed rearrangement any benefits to Northern from its preferred-supplier relationship with Bell will, as presently, flow to Northern's shareholders. Since Bell, the operating company, would no longer retain Northern's shares, subscribers would no longer have the benefit of any dividend flow* from Northern. Bell shareholders, of course, retain their interest in Northern through their shares in the proposed holding company. A dichotomy would be created between the interests of Bell shareholders and its subscribers which does not now exist. Inappropriate equipment purchases would harm subscribers and benefit Bell shareholders. Regardless of

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* Dividends received by Bell Canada from Northern averaged almost $16 million over the years 1978-1980. This is a small amount relative to Bell Canada's total revenues for these years. However, Northern retains most of its profits for reinvestment which should be reflected in increased dividends in the future. The capital gain on Northern's shares represents the anticipation of these increased dividends.

management's competence and interest in operating efficiently, it should not be placed in a position where the interests of shareholders and subscribers is so divergent.

While the proposed reorganization might appear to resolve the regulatory difficulties that now arise because Bell has a direct interest in both regulated and unregulated activities, basic problems remain. The separation between regulated and unregulated income would be clear. However, joint costs between the regulated operating company and the unregulated subsidiaries will still persist in some cases. It is not clear in such cases if subscribers should be insulated from the risks of the unregulated subsidiaries, nor is it clear that shareholders alone should enjoy the returns to risk when in fact their risk is reduced because of the continuing relationship with the regulated company.

This problem does not relate to all the subsidiaries. If, for example, BCE is responsible for providing management direction for the distribution of telecommunication terminal equipment, a reasonably complete separation of this activity from the operating telephone company activity can be expected to occur. Overseas telecommunication consulting services, however, present more difficulties.

As in the case of Bell's service agreements with a number of Canadian telephone companies, it must be assumed that what Bell has to sell overseas is derived from its experience gained in operating its own telecommunication networks. It is difficult to see how a subsidiary operating at arm's length could be established or why anyone would want

to insist on such a relationship. It is assumed that the resources essential to providing the service reside in Bell Canada and are called upon as needed. The removal of all income derived from the sale of overseas telecommunication consulting services from the flow of revenue used in determining the revenue needs of Bell Canada, as would result from the proposed reorganization, raises a serious question of fairness as between shareholders and subscribers. Although some limited support for a modified form of such a proposal can be found in Part I of the Report on telecommunication equipment, the proposal definitely runs counter to the essence of the discussion of this matter, which is found at pages 217-20. The Commission's view is that the total separation of income from operations in unregulated markets from income derived from regulated activities is appropriate where the unregulated operations do not benefit from the regulated activities. Where they do so, it is equitable that some of the benefits be returned to the subscribers. Bell's contract in Saudi Arabia was used as an example in Part I to illustrate this point.

The Commission's major concern is with Northern. As described previously, Northern in fact provides a product jointly with the operating company, and the shareholder's risk in Northern is reduced because of Northern's relationship to Bell. The equity consideration that results concerning the flow of income is only one of the issues raised. As indicated above, Bell's managers will face a more serious divergence between shareholder

and subscriber interest than currently exists when they make decisions on purchasing equipment. This problem, which is a very basic issue raised by vertical integration, will not disappear. Indeed, it will be exacerbated.

The other regulated telephone companies, which are now held as an investment, do not present such difficulties. Services they receive through their service agreements with Bell Canada are paid for by them, and their separation from the operating company as proposed would appear to be advisable.

CHAPTER IV

RECOMMENDATION

The proposed reorganization has a number of positive aspects. It could ease the task of the regulator in some areas and provide management with the freedom to manoeuvre that it probably requires if the Bell Group is to enlarge its range of activities. A number of serious problems with the proposed reorganization have been noted as well.

The facts used to discuss the reorganization are drawn from testimony before the Commission in the Telecommunication Equipment Inquiry. This report is unique in that the Commission has not had the benefit of argument on the specific issue that has been raised. The time available before the date for approval of the arrangement by the shareholders and the Superior Court would not permit us to reconvene the hearings.

We are not therefore in a position to make specific recommendations. We feel, however, that the public interest requires that a reorganization should not take place unless there has been full public consideration of the probable effects of the proposal, with respect to both subscribers and the telecommunication industry.

Member

Member

Ottawa
July 26, 1982

APPENDIX I

Restrictive Trade Practices Commission / Commission sur les pratiques restrictives du commerce

July 8, 1982

Mr. Warren Grover, Q.C.,
Blake, Cassels & Graydon,
Barristers & Solicitors,
P.O. Box 25,
Commerce Court West,
Toronto, Ontario,
M5L 1A9

Dear Mr. Grover:

Re: Telecommunications Equipment Inquiry

A number of newspaper articles concerning a proposal for the financial reorganization of Bell and its subsidiaries have come to the attention of the Telecommunications Equipment Inquiry Committee. The Committee is interested in obtaining, at the earliest possible date, information on the proposed reorganization. Without in any way limiting the information you may provide, the Committee has a number of specific questions.

1. What would be the relationship under the proposal between:
   a) the Bell Holding Company and the Bell Operating Company?
   b) the Bell Holding Company and Northern?
   c) the Bell Operating Company and Northern?

2. What would be the relationship of Bell-Northern Research to these corporate entities?

3. Are any changes planned in the relationship between Bell, BNR and Northern with regard to product development?

4. Are any changes planned in the existing supply agreement between Bell and Northern?

5. What would be the impact of the proposal on Bell Operating Company rate base and income flow as compared to the existing situation?

6. What is the timing of the proposed change?

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7. Does Bell consider it necessary to obtain a change in its charter, and therefore approval from Parliament, before implementing the proposal?

8. Does Bell consider it necessary to obtain approval from the CRTC before implementing its proposal?

Yours very truly,

Original Signed by
G. M. PAYETTE

G. M. Payette,
Secretary of the Commission

APPENDIX II

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July 21, 1982

G.M. Payette, Esq.,
Secretary,
Restrictive Trade Practices Commission,
P.O. Box 336,
Postal Station "A",
Ottawa, Ontario.
K1N 8V3.

Dear Mr. Payette:

Re: Telecommunications
Equipment Inquiry

In response to your letter of July 8, attached for your information is a copy of a document entitled:

Notices of Special Meetings of Shareholders

Information Circular

Notice of Motion

which contains detailed information with respect to the proposed reorganization. I believe that the document may provide you with all the information you require.

To answer the specific questions raised in your letter, I have contacted Bell Canada and would advise as follows:

1.a. It is intended that Bell Canada Enterprises Inc. (BCE) will become the holding company of Bell Canada, which will continue to be the operating telecommunication company in Ontario and Quebec and parts of the Northwest Territories.

b. BCE will own the shares now held by Bell Canada in Northern.

c. Bell Canada will be a sister company of Northern.

2/...

2. BNR will continue to be owned 70% by Northern and 30% by Bell Canada.

3. No.

4. No.

5. Bell Canada is currently regulated on the basis of total average capital, including an adjustment for regulatory purposes. The Company expects this rate base to continue unchanged with the exception that the regulatory adjustment would no longer be required. This is further explained in the third last paragraph on page 12 of the attached Circular, including the impact on income flows.

6. It is proposed to have the reorganization completed no later than December 31, 1982.

7. No amendment of the Bell Canada Act is required for the implementation of the proposed reorganization and accordingly, no formal approval by Parliament is required.

8. While the proposed reorganization is not subject to CRTC approval, Bell Canada's telecommunications operations will continue to be regulated by the CRTC after the reorganization.

I did not draft elaborate answers to the specific questions in view of your request that I reply promptly. Should you wish further clarification of the foregoing, please feel free to contact me.

Yours very truly,

Warren Grover.

WMHG/bp

Encl.